

reconsideration of such rules as part of the process of implementing COBAK would be likely to impose costs and would create the potential for harm to competition.

4. Implementing COBAK for local traffic before implementing it for toll traffic will not eliminate some regulatory arbitrage opportunities that could distort investment. Such implementation also would prevent the more efficient deployment of facilities that would result from a unified system of intercarrier compensation.

1. INTRODUCTION

The Notice of Proposed Rulemaking (NPRM) released by the Federal Communications Commission (Commission or FCC) in this proceeding seeks comment on the desirability of adopting a “bill and keep” scheme for all intercarrier compensation arrangements. In particular, the NPRM asks parties to comment on the COBAK and BASICs proposals.* This declaration discusses issues important for implementing the COBAK regime in a way that will facilitate the development of efficient competition in telecommunications markets.

Simply stated, the COBAK proposal is a system that assigns responsibility for the costs of facilities used to carry a call among different networks. The COBAK approach is designed to address problems and distortions created by the current interconnection regime, which generally requires the network originating a call to pay all of the costs of terminating the call on another network.³ Specifically, the COBAK scheme is intended to simplify intercarrier compensation rules, reduce the need for regulatory intervention, and eliminate distortions created by arbitrage opportunities, while promoting both efficient competition among telecommunications service carriers and efficient use of telecommunications infrastructure by consumers.

² See *In the Matter of Developing a Unified Intercarrier Compensation Regime*, FCC, CC Docket No. 01-92, Notice of Proposed Rulemaking, Adopted April 19, 2001 (henceforth “01-92 NPRM”). Also see Patrick DeGraba, “Bill and Keep at the Central Office as the Efficient Interconnection Regime,” FCC, Office of Plans and Policy Working Paper #33, December 2000 (henceforth “DeGraba 2000”); and Jay Atkinson and Christopher Barnekov, “A Competitively Neutral Approach to Network Interconnection,” FCC, Office of Plans and Policy Working Paper #34, December 2000.

³ See DeGraba 2000 at ¶¶ 16-20 for a discussion of these problems.

Implementation of a COBAK regime for intercarrier compensation will not reduce or eliminate many of the underlying sources of the market power possessed by incumbent LECs, including their control of important network facilities and their economies of scale. Nor will COBAK eliminate other advantages that incumbent LECs enjoy as a result of their decades of operation as government-sanctioned monopolies. Incumbent LECs, for the most part, would retain under COBAK existing incentives and abilities to exercise market power and disadvantage their rivals, thereby limiting the development of efficient competition and harming consumers. Hence, rules that constrain the exercise of incumbent LEC market power will continue to be essential to achieving efficient pro-competitive outcomes under COBAK, just as they help promote more efficient outcomes under the current interconnection regime.⁴

Changes in carriers' cost responsibilities resulting from COBAK, however, could change the ways in which incumbent LECs attempted to disadvantage competitors. This declaration identifies two new ways in which incumbent LEC market power might be manifested under a COBAK regime.

1. Under CORAK, incumbent LECs would bear the cost of transporting originating interexchange toll calls to an interexchange carrier (IXC) point of presence (POP). If incumbent LECs are also given control over the routing of such traffic, they could route the traffic in ways that would make it more difficult for IXCs to monitor the handling of calls originated by their customers (*i.e.*, to determine blocking rates), and could prevent the competitive IXCs from realizing the economies of scale they now enjoy by combining the transport of originating and terminating access traffic. This would limit the ability of IXCs

⁴ DeGraba 2000 recognizes the importance of constraining incumbent LEC market power under a COBAK regime, but does not discuss the issue in detail. For example, DeGraba 2000 recognizes the need to regulate incumbent LEC transport rates to other carriers where the incumbent LEC remains dominant in the provision of such facilities, so that competitors can obtain transport on the same cost basis as the incumbent (see DeGraba 2000 at ¶¶ 120-121). It also recognizes the possibility of needing to regulate incumbent LEC end user charges in order to prevent them from both setting retail rates above cost and, more importantly, setting discriminatory rates for services that are complementary to those provided by competitors for the purpose of disadvantaging those competitors (*Id* at ¶¶ 123-132). The NPRM also recognized the potential problems posed by incumbent LECs' incentives to disadvantage rivals. The Commission sought comment on the ability of incumbent LECs to engage in a predatory price squeeze (01-92 NPRM at ¶¶ 15 and 55), and on the need to continue to regulate incumbent LEC transport rates (*Id* at ¶ 61).

to compete effectively, especially with the interexchange service offered by incumbent LECs, thereby harming consumers.

2. Under COBAK, incumbent LECs would recover directly from end users costs they now recover from IXC (in particular those of originating access, switching, and transport). Existing rules constrain the structure and level of rates that incumbent LECs charge IXCs for these services. Similar constraints would be needed under a COBAK system to prevent incumbent LECs from disadvantaging rival IXCs. For example, even if the *level* of cost recovery were constrained by regulation, incumbent LECs might be able to disadvantage rival IXCs by recovering these costs from customers of competing IXCs with a less efficient rate structure than that used to recover the same costs from customers of their own interexchange service. Such differences in rate structure likely would make IXC service less attractive than the incumbent LEC's interexchange service, particularly for high volume toll users. Because IXCs would become less effective competitors, consumers would be harmed.

The two examples outlined above do not imply that COBAK gives to incumbent LECs new sources of market power. That market power derives from their control of assets that cannot be duplicated in a cost-effective manner by competitors. COBAK simply creates new ways for incumbent LECs to exercise their existing market power.

This declaration also examines the constraints on incumbent LEC market power as COBAK is implemented for services for which cost responsibilities do not change. The cost responsibilities of interconnecting carriers for the transport and interconnection of local calls would be the same under COBAK as they are under the current regime. Hence, COBAK is unlikely to change the ways in which incumbent LECs could try to exercise market power in the provision of these services. Because the Commission has already adopted rules that are designed to constrain these ways of exercising market power, new or additional rules likely would not be necessary if a COBAK scheme were adopted. Indeed, general reconsideration of these rules as part of the process of implementing COBAK would likely impose costs and create the potential for harm to competition.

Finally, this declaration considers some consequences of “piecemeal” implementation of COBAK, first for local service and only later for interexchange service. Such a piecemeal approach would perpetuate some existing arbitrage opportunities that could distort investment and delay the realization of potential efficiencies resulting from a unified system of interconnection.

The remainder of this declaration is organized as follows. The next section discusses generally the incentive and ability of incumbent LECs to disadvantage competing rivals in ways that would harm competition and consumers. The remaining four sections deal with the implementation issues identified above. Section 3 analyzes the opportunity for incumbent LECs to disadvantage rivals by rerouting the originating toll traffic for which they would have cost responsibility under COBAK. Section 4 analyzes the opportunity for incumbent LECs to disadvantage rivals regarding the structure and level of rates used to recover from end users costs assigned to them by COBAK. Section 5 discusses where, under COBAK, existing rules constraining the exercise of incumbent LEC market power can continue to be used. Section 6 discusses problems associated with implementing COBAK on a piecemeal basis. Section 7 summarizes the conclusions of this analysis.

2. INCENTIVES AND ABILITIES OF AN INCUMBENT LEC TO EXERCISE MARKET POWER AND DISADVANTAGE RIVALS

2.1. Competing carriers’ dependence on incumbent LEC facilities

A firm will possess market power when it controls facilities or services that its rivals need to offer competing products or services for which the rivals cannot find alternatives that are comparable in cost and quality. Because incumbent LECs for many years provided local exchange and exchange access services as government-sanctioned monopolies, they still control many such network facilities and assets. For example, the incumbent LECs operate extensive local and regional transport networks with virtually ubiquitous reach and enjoy the resulting economies of scale and scope.’ On many routes the cost of adding a level of incremental

⁵ Note that these ubiquitous networks were built in a virtually risk-free environment. With monopoly franchises and rate-of-return regulation, incumbent LECs were virtually guaranteed a reasonable return on all of their investment in

capacity for an incumbent LEC is much lower than the cost to a new entrant of installing a new facility with the same level of capacity. In these cases it would be more efficient for society for the incumbent LEC to expand its capacity and allow competitors to use it, rather than to require the competitor to construct new capacity. Similarly, for the foreseeable future, the incumbent LEC will be the only economically feasible supplier of local loop access facilities to many end users. As with their transport networks, incumbent LECs constructed their existing, ubiquitous loop facilities when they were protected by statutes and regulations against competitive entry. It will not be cost-effective for competing carriers to construct new loops to serve many customers, particularly those located in less densely populated areas or far from the central office.

Consequently, competing carriers may not be able to obtain some inputs that they need to offer service in local markets, either by building their own facilities or by leasing them from other new entrants on a cost-effective basis. Their only alternatives are to rely on incumbent LECs for those inputs or to face a cost or quality disadvantage. For example, when IXC's rely on an incumbent LEC's tandem-switched transport, it is likely because they cannot obtain these services from another source on a cost-effective basis.

In addition, customers of competing carriers may have no good alternatives to purchasing complementary services from incumbent LECs that are needed to use the service of these competing carriers. For example, under COBAK, customers of an IXC would purchase originating access to the IXC's POP from their LEC. The quality of the long distance call will depend in part on the quality of the access service provided by the LEC.

The simple fact that a firm supplies inputs to its rivals, or complementary service to customers of the rivals, does not necessarily give that firm market power or the ability to disadvantage its rivals. It gains that ability when rivals, or customers of the rivals, cannot turn to alternative sources of supply that are comparable in cost or quality. Absent a comparable alternative, the rivals or their customers have only the choice of accepting the higher cost or reduced quality of the first firm's service, or of accepting the higher cost or reduced quality of

infrastructure. Entering competing LECs today do not have this luxury and so, quite naturally, will likely build transport facilities to fewer locations. (In fact, even after years of interexchange competition, there are still locations in the United States that WorldCom does not serve via its own network. In these areas, WorldCom purchases services or leases facilities from AT&T, whose presence is a legacy of its monopoly franchise.)

the inferior alternative. Either choice leaves a rival at a disadvantage in the marketplace. This is precisely the position in which competing carriers that rely on incumbent LEC inputs or complementary services find themselves. In such cases the incumbent LEC has market power.

2.2. Incentives of the incumbent LECs to exercise market power

An incumbent LEC supplying inputs for which there are no good, cost-effective substitutes typically has two strategies it might utilize to exercise its market power. First (absent regulation), it can charge prices above cost and maximize the profits it earns from selling those inputs for which it faces little or no competition. Second, it can exercise its market power to disadvantage rivals that use its inputs and with which it competes in downstream markets.

2.2.1. Simple profit maximization

When an incumbent LEC controls facilities for which there are no (or few) cost-effective substitutes, competition will not prevent it from setting prices above cost. State and federal agencies use price-cap and cost-of-service regulation to prevent incumbent LECs from setting rates for their services at monopoly levels. In many cases, COBAK would not eliminate an incumbent LEC's ability to set prices above cost absent regulatory constraints, although it may change who would be charged the higher prices. Under a COBAK regime, for example, the originating local exchange carrier would be responsible for the costs of delivering a call to an IXC's POP. Consequently, an incumbent LEC likely would recover that cost from the end user originating the call, instead of from the IXC, as it does today. In that case, in adopting a COBAK system, the FCC would need to implement safeguards to prevent an incumbent LEC from assessing the end user prices above cost, just as access charge rules prevent the incumbent LEC from assessing too high a price on IXCs today.⁶

⁶ It has been argued that any LEC that terminates interexchange traffic for its customers, whether or not an incumbent, is a monopolist with respect to such termination services. The reason is that once a customer chooses a LEC, and no other carrier offers access to that customer's premises, an IXC has no alternative but to use the LEC for termination services, regardless of how many LECs compete to serve the customer. COBAK could eliminate this market power because the LEC would not be allowed to charge the IXC for terminating switching, and would likely recover these costs from the end user customer. In instances where there is sufficient competition in the provision of local service, the LEC would be unable to charge above-cost rates for terminating switching.

2.2.2. Disadvantaging competitors

As noted above, a firm with market power over inputs used by its rivals has the ability to use that power to disadvantage its competitors in downstream markets. Whether the supplier with such market power will have an incentive to disadvantage rivals will depend on a comparison of the cost and benefits of such a strategy. The supplier can disadvantage rivals by raising the price of the input above the level that maximizes profits from sale of the input itself, by refusing to sell the input, by degrading its quality, or by some combination of these strategies. Each alternative reduces the profits earned directly from the sale of the input. However, disadvantaging the rival in this way allows the firm to earn higher profits from the sales of services that compete with the services of its rivals downstream. The supplier with market power has an incentive to disadvantage rivals only if the foregone profits from its input sales are less than the resulting additional profits it earns from its services that compete with rivals downstream.⁷

Existing regulatory restrictions on price likely contribute to the incentive of incumbent LECs to use their market power to disadvantage rival carriers. Regulation generally limits the prices that an incumbent LEC may charge for inputs or complementary services for which there are no adequate substitutes. Such constraints (such as price caps) limit profit margins on the direct sale of these services. An incumbent LEC makes fewer sales of these inputs if it degrades their quality but, in so doing, will sacrifice less profit from direct sales than it would if it were free to charge whatever it liked for those services.⁸ If such degradation in quality were to give the incumbent LEC a significant advantage over its rivals, the strategy would result in additional profits in the end user markets that would likely exceed the loss of constrained profits in the input markets. Consequently, the incumbent LEC is likely to have an incentive to disadvantage rivals by withholding or degrading the quality of those inputs.

⁷ If the strategy instead involves the monopolist's control over a complementary service purchased by consumers who also are customers of its downstream rival, the firm must balance foregone profits from sales of the complementary service against increased profits from its downstream operation.

⁸ Indeed if the regulated price allowed the incumbent LEC to recover only its long-run costs, then in the long run, the incumbent LEC would forgo no profits as a result of such a strategy.

For example, an incumbent LEC that provides unbundled loops to a competing LEC will earn only limited profits from doing so if it is required to supply those loops at rates based on Total Element Long-Run Incremental Costs (TELRIC). If, instead, the incumbent LEC were to disadvantage the competitive LEC by, say, failing to provision loops on time, some customers who otherwise would shift to the rival service likely would continue to purchase retail service from the incumbent LEC. As a result, the incumbent LEC would earn profits from the sale of retail services to those customers that likely would be higher than the profits from selling the loops as inputs to competing service providers.

Of course, prices for some services that the incumbent LEC sells to end users also are limited by regulation. Nonetheless, there are many instances in which the additional profits from increased downstream sales will outweigh the lost profits from the sale of inputs due to disadvantaging rivals. Many incumbent LECs, for example, are subject to price-cap regulation at the federal and state levels for end user services. Because prices and revenues for such services are not directly constrained to equal costs, incumbent LECs likely have an opportunity to earn substantial incremental net revenues from additional sales.⁹

Moreover, not all incumbent LEC downstream services are subject to price regulation. Customers generally buy not only basic local service but also packages of related, complementary services. Residential customers buy vertical services and interexchange service, while business customers purchase a wide range of telecommunications services. The prices of some of these services are relatively unregulated.

Incumbent LECs are also likely to have an incentive to disadvantage rivals to maintain their market power by maintaining their position as the supplier of facilities for which there are no good economic substitutes. In other words, incumbent LECs have an incentive to erect barriers to entry. Evolving competition would threaten not only profits from end users but also, over time, profits from the sales of inputs. As competing carriers grow and build their networks, they become less and less dependent on incumbent LEC inputs. For example, as competitive

⁹ This does not imply that price-cap regulation is undesirable. One of its benefits is that the regulated **firm** has increased incentives to reduce costs or improve quality because it keeps any net revenue that results from lowered costs or increased sales. The **firm**, however, also then has an incentive to defend that stream of net revenue.

LECs build larger customer bases, they are finding it profitable to build more of their own transport facilities and to rely less heavily on incumbent LEC facilities and services. In the longer run, the desire to protect market power increases the incentive to disadvantage rivals.

Evidence that incumbents are not providing facilities at the required quality level would be consistent with the notion that, in some circumstances, incumbent LECs do not have the incentive to provide facilities to their competitors. There are numerous examples of such behavior on the part of incumbent LECs.¹⁰

2.3. COBAK's effect on the ability and incentive of incumbent LECs to disadvantage rivals

A COBAK regime in most instances would neither create nor eliminate the ability and incentive of incumbent LECs to disadvantage rivals.¹¹ Regardless of the assignment of cost responsibility for inter-carrier calls under COBAK, incumbent LECs would still control assets for which there are no cost-effective substitutes. It is the control of these assets that gives the incumbent LEC its market power and ability to disadvantage rivals. COBAK may create new ways in which incumbent LECs would be able to use their dominant position to disadvantage competitors. A change in an incumbent LEC's cost responsibility will also change the parties from whom the costs are recovered. This will create new decisions for an incumbent LEC, decisions concerning how to provision the services and how to recover their costs. As explained in the next two sections, this may present an incumbent LEC with new opportunities to disadvantage rivals. Consequently, when implementing COBAK, the Commission should consider these new opportunities that incumbent LECs may have to disadvantage rivals and adopt rules that will curb their ability to exploit those opportunities.

¹⁰See, for example, "SBC Pays \$3.2 Million For Falling Short On Performance," *TR Daily*, July 27, 2001, citing the fact that SBC "has paid more than \$38 million for falling short of standards that were set when the FCC approved the merger of SBC and Ameritech Corp." See also, "Verizon to Make 1.5M Payment for Performance Shortfall," *TR Daily*, August 8, 2001, noting that Verizon Communications, Inc., will make a payment of \$1.5 million to the U.S. Treasury later this month for failing to meet performance standards for its delivery of services and network elements to competing carriers.

¹¹ The one instance in which COBAK could eliminate a LEC's market power is with respect to terminating switching. Regardless of the number of competitors in a market, an end user's carrier is a monopolist with respect to terminating calls to that end user. COBAK would require a carrier to recover terminating switching costs from its end user, a provision that would eliminate this market power if there were sufficient competition for end users.

3. AN INCUMBENT LEC COULD USE CONTROL OVER THE ROUTING OF ORIGINATING INTEREXCHANGE TRAFFIC TO DISADVANTAGE IXCS AND HARM CUSTOMERS.

Under the current access regime, incumbent LECs sell access services as inputs to IXCs that sell interexchange services to end user customers. Price caps on access charges limit the ability of an incumbent to exercise market power over the supply of this input. Adoption of a COBAK regime would change the rules under which these services are supplied, but, as noted above, would not affect an incumbent LEC's market power in the provision of these services. Under COBAK, incumbent LECs would be assigned the cost responsibility for transporting *originating* traffic to the POPs of IXCs. As a result, incumbent LECs would no longer sell originating access to IXCs as an input to their long distance service. Rather, incumbent LECs would need to recover the costs of carrying that traffic directly from the end users originating the calls. Sold directly to end users, originating access would become a complementary service consumed together with the interexchange services of IXCs. At the terminating end of a toll call, an IXC would remain responsible for delivering traffic from its POP to the incumbent LEC end office serving the called party, but the called party's LEC would assume the cost of terminating the call.

As discussed below, these changes in the way in which access service is provided will create new opportunities for an incumbent LEC to use its market power to gain an anticompetitive advantage over its rivals, to the detriment of competition and consumers. First, an incumbent LEC could exploit the new intercarrier compensation scheme to raise the costs of inputs that its competitors need relative to the costs of those inputs to the incumbent LEC. Second, an incumbent LEC could raise the cost of originating access to end user customers of IXCs.

3.1. The routing of access traffic

IXCs currently are responsible for the cost of carrying both originating and terminating traffic between end offices serving the calling and called parties and their POPs. As a result,

IXCs choose the network configurations that are used to carry this traffic.¹² Many IXCs employ dedicated facilities to carry traffic between their POPs and incumbent LEC end offices.¹³ It is my understanding that facilities on many routes are leased from the incumbent LEC via long-term contracts. On routes on which traffic levels are sufficient to make it cost effective for non-incumbents to build their own facilities, IXCs typically own their own facilities or lease them from non-incumbent LEC suppliers. Alternatively, IXCs may use dedicated links between their POPs and an incumbent LEC tandem-switching office and purchase tandem-switched transport service from the incumbent LEC to carry traffic between the tandem and the end office serving the called party. This option typically will be chosen for routes on which the volumes of traffic are so small that it is not cost-effective to lease dedicated circuits. Overflow traffic from dedicated trunks will also be routed via tandem-switched transport.

Dedicated two-way trunks to the end office have advantages over both dedicated one-way trunks and connection at the tandem. Two-way trunks are less expensive than one-way trunks, given sufficient traffic, and dedicated trunks allow for better monitoring of traffic blockage than does connection at the tandem.

It is my understanding that routing originating and terminating traffic on a single two-way trunk results in lower costs per unit of traffic than routing the two on separate one-way trunks for several reasons. First, there are economies of scale in trunking. The cost per unit of capacity falls as trunk size increases because a single trunk of a given capacity is less costly than two trunks of half that capacity.¹⁴ Second, if the peak for originating traffic occurs at a different time than the peak for terminating traffic, then some of the same capacity on two-way trunks can be used for both peaks. Since this cannot be done if originating and terminating traffic is carried on separate one-way trunks, carrying both on a two-way trunk may reduce the total trunk capacity required to carry the traffic. Finally, the probability distribution of traffic is such that the capacity required to accommodate traffic with a given probability of blocking increases less

¹² IXCs choose all network configurations to carry traffic to the end office, even if tandem access is used, in the sense that they choose tandem access rather than an alternative.

¹³ In many instances the direct trunk runs from the end office to the entrance facilities serving the POP rather than directly to the POP. This technical fact has no effect on this analysis.

¹⁴ This is true with regard to both the costs of constructing trunks and the pricing of trunks.

than proportionately with the total volume of traffic. This technical trunking efficiency is another reason that less total capacity is required to carry originating and terminating traffic on a single trunk than is required to carry the same traffic on separate one-way trunks. Of course, reducing the total trunk capacity required to carry traffic also reduces the average transport cost per unit of traffic.

IXCs can more effectively monitor the volume of traffic from the end user to the POP over direct trunks, and ensure lower blocking rates, than if they connect at the incumbent LEC tandem. As I understand it, end office switches are provisioned to be effectively non-blocking, and therefore an IXC can be reasonably confident that all traffic generated at a central office will be presented to the trunk connected to its POP. The IXC can observe these traffic levels and control blocking on the trunk between the end office and its POP through its own choice of circuit capacity. By contrast, when an IXC purchases tandem-switched transport, it is able to monitor and control blocking only on the circuits that connect its POP to an incumbent LEC tandem. An IXC is not able to observe or control blocking between the tandem and the end office. Consequently, when an IXC uses tandem-switched access service for transport, it is more reliant on the incumbent LEC to ensure a given quality of service.

Under a COBAK regime, IXCs would be responsible for the cost of transporting access traffic between POPs and end offices only in the “terminating” direction. Incumbent LECs would be responsible for the cost of transporting traffic in the originating direction. Given their cost responsibility for originating transport, one might argue that incumbent LECs should also have the right to determine how to route originating access traffic. If this were the case, then IXCs would only be able to determine which facilities carry terminating traffic.

DeGraba 2000 hypothesized that the incumbent LECs would choose to route originating access traffic over the same facilities that are used today.” Such a choice would make sense so long as the incumbent LEC’s motivation was to minimize the cost of transport. As discussed, however, the incumbent LEC instead likely has an incentive to disadvantage interexchange

¹⁵ The expectation would be that if originating and terminating traffic were relatively balanced, the IXC and the incumbent LEC would form a “meet point” arrangement using the existing trunk groups, with each carrier maintaining the half of the trunk closest to its switch. (See DeGraba 2000 at ¶ 73.)

rivals. Choosing to route traffic over facilities other than those currently used by the IXC's could disadvantage IXC's in three ways.

3.1.1. Rerouting originating access traffic can raise an IXC's average cost of terminating access traffic.

If an incumbent LEC routed originating access traffic over different transport facilities, an IXC's dedicated trunks would carry less traffic. As a result, the effective cost per unit of traffic for the IXC of carrying terminating traffic would rise because it would lose trunking economies of scale that resulted from carrying both originating and terminating traffic on the same trunk. Thus, by removing the originating traffic from direct trunks used by IXC's, an incumbent LEC could raise IXC's cost of providing terminating access relative to its own cost of providing such access to its own interexchange service. Presumably, an incumbent LEC can insure that it realizes all economies available from combining originating and terminating traffic in carrying traffic between its end offices and the POPs of its own interexchange service.¹⁶

Such an increase in the IXC's effective cost of terminating transport access would make IXC's less competitive and prevent them from charging as low a price as they could if they were able to share in the economies of scale obtainable by carrying both originating and terminating traffic over the same dedicated trunks. In particular, by effectively raising the IXC's cost of providing terminating transport, the incumbent LEC reduces the IXC's incentive to lower its prices to win additional customers (and therefore handle increased traffic).

3.1.2. Rerouting originating traffic can increase the IXC's costs by stranding assets

An incumbent LEC's decision to route originating access traffic over facilities other than the dedicated trunks currently leased by an IXC could raise IXC costs in a second way, by stranding assets of the IXC. As noted above, IXC's typically have entered into long-term leases for the dedicated trunks they use to transport access traffic or, in some instances, have

¹⁶ In addition, the incumbent LEC may be less concerned if the separation of originating and terminating traffic raises its costs of carrying originating traffic to the IXC POP, particularly if the higher costs can be used to justify higher rates to end users for origination services used in conjunction with the IXC interexchange service.

constructed their own transport links. Therefore, a decision by the incumbent LEC to route originating access traffic over different transport facilities from those currently used by the IXC's could leave the IXC's with substantial excess transport capacity on these dedicated trunks.

Such a situation likely would cause prices for switched IXC services to decline without a commensurate reduction in IXC's costs. Competition from incumbent LEC interexchange service would tend to force prices for interexchange service to fall. Incumbent LECs, who would recover these originating transport costs in their local rates, presumably would set rates for their long distance service to reflect incremental costs of interexchange service that include only interexchange transport and terminating transport, but not originating transport. To be competitive, IXC's also would have to set lower rates that would not recover the costs of originating transport. An IXC with sunk costs in trunk capacity to carry originating traffic, however, would not see a reduction in costs commensurate with the reduction in price.¹⁷ The IXC, *ceteris paribus*, instead would experience a reduction in profits. This reduction in profits, in turn, may increase an IXC's cost of acquiring capital that it needs to upgrade and expand its network. An increase in an IXC's cost of capital increases its costs of service and hinders its ability to compete with incumbent LEC interexchange service.

Reduced profits for an IXC can raise its cost of capital in three ways. First, a loss in profit for an IXC would increase its chances of defaulting on its debt, a change that would be reflected in higher costs to obtain debt and equity financing. Debt financing would be more expensive because the increased probability of default would cause lenders to insist on higher interest rates. Equity financing also would become more expensive because lower profitability would result in lower prices for the IXC's stock. The lower the stock price is, the greater the ownership share in the firm that must be sold to raise a given level of capital by sale of equity.

Second, a reduction in profits reduces an IXC's ability to finance projects internally. A reduction in internally generated funds potentially limits the total financing available to fund new projects to the extent that the IXC is subject to credit rationing (that is, to sharp limits on the funds it can borrow in external capital markets). Such credit rationing could be imposed by the

¹⁷ The severity of such a problem will depend on whether there are alternative uses for this capacity, including using it to carry growing terminating traffic.

market's reluctance to invest in the industry, or by covenants with existing bond-holders that limit the amount of outside financing a firm may obtain.

Finally, internal capital financing may be less expensive than external financing. This could occur, for example, because the firm is more optimistic about its business prospects than is the market, either due to insiders having better information about the firm's prospects or insider overconfidence. Regardless of the reason, to the extent that the market is less optimistic about the firm's expected future cash flows than the firm's insiders, those insiders will perceive the cost of finance raised from external sources as exceeding their own assessment of the cost of using internally generated funds. In such a case, reducing a firm's source of internal capital increases its perceived cost of capital and reduces its incentive to expand.

3.1.3. Rerouting originating traffic can allow the incumbent LEC to increase blocking rates of traffic originated by IXCs' customers

Moving originating transport from dedicated trunks leased by an IXC to an IXC's switched network makes it easier for an incumbent LEC to degrade the quality of the service it provides to an IXC without detection. As noted above, when an IXC interconnects with an incumbent LEC network at a tandem, the IXC is unable to monitor blocking that occurs "behind the tandem," that is, between central offices and the tandem. Thus, an incumbent LEC could under-provision trunks carrying originating traffic to tandems for transport to the IXC's POP. This strategy would increase blocking rates experienced by the IXC's end user customers relative to the incumbent LEC's interexchange customers, lower the perceived quality of the IXC's service relative to the incumbent LEC's service, and, consequently, place the IXC at a competitive disadvantage. Because the IXC cannot monitor traffic flows behind the tandem, it would be difficult to detect such degradation and force correction.

Thus, incumbent LECs could have incentives to move originating traffic bound for IXC POPs from the direct trunks over which it now is carried, even if doing so lowered neither the incumbent LEC's costs of transporting that originating traffic nor the overall costs of transporting originating plus terminating traffic. The incumbent LEC's motivation might instead be one of degrading the quality of service of a rival provider of interexchange service.

3.2. It is unlikely that routing originating traffic differently from terminating traffic would be efficient

It is important to ask if an incumbent **LEC** could justify moving originating traffic off the IXCs' dedicated trunks on efficiency grounds. I will explain below that if it were efficient to move originating traffic off the IXCs' dedicated trunks, it would most likely be efficient to move terminating traffic off these trunks as well. Thus, it is unlikely that there would be an efficiency justification for routing originating traffic over facilities other than those used for terminating traffic.

An IXC routes originating and terminating traffic over two-way dedicated trunks between its POP and an end office because it finds this preferable to the use of tandem-switched transport. Direct end office trunking may be the lowest-cost option, given the cost of the trunks and the pricing of tandem routing. Alternatively, direct end office trunking may be somewhat more costly, but the IXC is willing to bear those costs because it values the ability to prevent the type of undetectable blocking that could occur with tandem-switched transport.¹⁸ Why would the network configuration that appears most efficient for the IXC not also be most efficient when the incumbent **LEC** is handling originating transport?

One possibility is that the regulated price of tandem-switched routing overstates its true cost relative to the cost of direct trunking. (This could be a result of specific local conditions – such as excess incumbent **LEC** capacity in a particular area and therefore low incremental costs for the incumbent **LEC** tandem routing – or a more general divergence between pricing and costs.) In this situation, it is conceivable that the incumbent **LEC** would shift traffic to its own facilities because it incurs the true cost of using those facilities, rather than a cost equal to the price that overstates cost.

If this is the reason for the shift, however, it is likely to be more efficient to also shift terminating traffic from the direct trunk. Presumably, the same divergence between price and true cost applies to terminating traffic, and hence implies that the true cost for the incumbent **LEC**'s routing of terminating traffic is lower than the cost to the IXC of direct trunking. Thus, if

¹⁸ Another possibility is that the IXC saves the greater costs of attempting to monitor and enforce quality when it uses tandem routing.

it were efficient to shift originating traffic to different routing, it also would be efficient for the IXC's terminating traffic to be routed in this manner. However, for the IXC to benefit from such a change in routing traffic, it would have to pay a price equal to the true cost of this routing, which would not only be lower than the price that overstates the cost of tandem-switched routing, but also would be lower than the cost to the IXC of using two-way dedicated trunks.

Another possibility is that the incumbent LEC does not value the IXC's ability to monitor and ensure low blocking, and so would be unwilling to incur the additional cost of the direct trunk." The IXC, however, believes customers would prefer to bear the additional costs of transport (reflected in higher prices for their service) to avoid the potential for blocking. There is no reason to believe these preferences of customers would change with COBAK's shift of cost responsibility, however, and therefore little reason to think the incumbent LEC would be acting efficiently if it shifted traffic because it did not value the IXC's ability to monitor blocking and quality.

Therefore, it is unlikely that it would be efficient for an IXC's originating traffic to follow a different transport path than its terminating traffic. Thus, rules that did not at least allow the IXC to ensure that both its originating and terminating traffic were routed over the same transport path could allow the incumbent LEC to disadvantage the IXC. In addition, because some routing is more susceptible to incumbent LEC quality manipulation than other routing, simply allowing the IXC to ensure that all of its traffic follows the same path, regardless of which path that is, may not be sufficient to prevent the IXC from being disadvantaged.

4. INCUMBENT LECS COULD MANIPULATE RATE STRUCTURE TO IXC'S END USERS TO DISADVANTAGE IXCS.

In a COBAK regime, an incumbent LEC would have to recover the costs of originating switching and transport for interstate calls directly from the end user rather than from the IXC. In that event, an incumbent LEC could no longer disadvantage IXCs by manipulating the price or quality of originating access sold to IXCs as an input. An incumbent LEC, however, could attempt to disadvantage its rivals by manipulating the structure of rates it charges its large

¹⁹ In fact the incumbent LEC would likely prefer that the IXC were unable to monitor blocking levels.

customer base for originating interstate switched access service, which would be complementary to an IXC stand-alone service. An incumbent LEC's charging higher or less attractively structured rates for originating access to customers of a rival IXC than to customers of its own interexchange service clearly would place competing IXCs at a significant disadvantage in the marketplace.²⁰

For example, an incumbent LEC could assess customers a higher rate per minute or per call to originate interexchange calls carried by rival IXCs than to originate calls carried by its own interexchange service. However, it is unlikely that such discrimination would be permissible.

Rival IXCs, however, also could be disadvantaged by more subtle pricing strategies. Suppose that the overall level of cost or revenue an incumbent LEC can recover for originating switched access services is capped, but the incumbent LEC were free to use any rate structure it wishes. An incumbent LEC that provides long distance service could disadvantage rival IXCs by recovering these costs on a per-minute basis from IXC customers, while recovering them from customers that subscribe to its own long distance service with flat rates or a combination of flat and usage rates. For example, an incumbent LEC might have a "standard" rate plan available to all that sets a per-minute fee for originating access for each interstate call. At the same time, it could offer consumers who use its local and long distance service a package price that includes regulated flat-rated local service, recovery of these "interstate costs" on a flat-rated basis, and a competitive per-minute charge for long distance service. Alternatively, the incumbent LEC might offer its own customers a package price with a flat charge that covered local calling plus a block of interexchange calling (which could be restricted to off-peak times) that included origination services for that calling.

Such rate structures would make the effective usage rate for the competing IXC service, including originating access, higher than the effective usage rate for the incumbent LEC service, even though the competing IXC charges only a competitive per-minute rate for interexchange

²⁰ Note that while I couch the discussion in terms of interstate access, this analysis applies to any service provided by an incumbent LEC and competitors in which the incumbent LEC also has market power in the provision of complementary services. Thus, an incumbent LEC would have the same incentives to charge discriminatory rates between customers that used the incumbent LEC's Internet service and those that used a competing ISP.

usage itself. Hence, the incumbent **LEC** can disadvantage competing **IXCs** by choosing such combinations of rate structures.

IXCs would be disadvantaged if their customers were charged a simple per-minute rate for origination because that rate structure causes customers to restrict their usage and limits the benefits they receive from the service. The customer of the incumbent **interexchange** service who pays a flat charge, or a mixture of flat and low usage charges, is encouraged to call more than if he or she were paying a simple high per-minute charge, and therefore receives more benefit from interexchange service. Indeed, because a customer receives more benefit from a flat-rated service, it would be possible for the incumbent **LEC** to earn more revenue by charging such rates, while still making the customer better off than if the customer used the **IXC** service and had to pay straight usage charges.²¹ By offering the more attractive rate structure to customers of its own interexchange service, but not to customers of rival **IXCs**, incumbent **LECs** can discourage customers from choosing the rival service.

Such a strategy would harm both competition and customers. Competition would be harmed, either because an **IXC** competing with an incumbent **LEC**'s long distance service would not be able to match the prices that consumers paid for the latter's service (originating access plus the **IXC** toll charges), or because the incumbent **LEC** would be able to charge a higher price than it otherwise would if consumers paid the same prices for originating access. The pricing strategy makes the **IXCs**' service less desirable, so they would serve fewer customers and at a lower price than if the incumbent **LEC** collected interstate costs from all customers on the same basis.

²¹ Formally, if an incumbent **LEC** charged an **IXC**'s customer a usage rate, r , for origination that exceeded the marginal cost of providing origination, it could make that customer better off *ceteris paribus* by offering him/her a usage fee equal to the marginal cost of origination and a fixed fee equal to the difference between r and the marginal cost of origination multiplied by the number of minutes the customer would have originated facing an origination rate of r . Given this plan, the customer would have the same total cost as when facing the rate, r , but would consume more minutes of calling. The incumbent **LEC** could then earn more money by charging a fixed fee equal to the fixed fee described above plus the dollar value of the benefit customers receive from the additional calls they would make described above.

Note that one instance in which the incumbent **LEC** cannot manipulate the rate structure to disadvantage its rivals is if it is constrained to collect revenue equal to the total variable cost of providing origination service. If marginal cost is a constant, c , then this implies a regulation that requires $r = c$. If competitors' customers face a rate of $r = c$, then setting a lower usage rate implies that customers pay a rate less than marginal cost.

Customers also would be harmed. Those who use the competing IXC services would pay a higher usage charge and receive lower benefits from the services than they would if the incumbent LEC set rates efficiently. Those who use the incumbent LEC interexchange service also would pay higher prices because the incumbent LEC service is less constrained by competition from rival IXCs who are disadvantaged by the incumbent LEC pricing. Even though the flat-rated pricing plan encourages more usage and generates more benefit for customers of the incumbent LEC's interexchange service, the incumbent LEC would be able to extract most of this benefit in the form of higher flat-rated charges. The disadvantaged IXC could not provide a sufficient constraint on the incumbent LEC's price level and could not constrain the structured prices for originating access that the incumbent LEC sets for its customers.

Under the current access regime, an incumbent LEC that offered interexchange service would like to structure the rates it charges IXCs as simple per-minute rates. This rate structure for access charges would change the cost structure of competing IXCs and force them away from including flat charges in their rates and toward a greater reliance on usage charges. The interexchange services of an incumbent LEC, because it would provide access to itself at a lower per minute cost than it would charge competitors, would be able to rely more on flat charges while offering lower usage rates. This would give incumbent LECs a competitive advantage for the reasons already explained. Current access regulations, however, limit the ability of incumbent LECs to disadvantage rivals by structuring access costs as per-minute rates only. Similar safeguards on the structure of pricing originating access to end users would be needed under COBAK.

As noted above, an incumbent LEC can disadvantage competing IXCs only to the extent it has market power over facilities that IXCs need and cannot reproduce cost-effectively. It is important to ask if the unbundled network element platform (UNEP) or total service resale (TSR) could provide a cost-effective method for the IXC to obtain all of its facilities and offer a bundle of local and long distance service. The analysis below suggests these methods do not provide a viable alternative because they rely on the incumbent LEC for provisioning and/or pricing.

First, consider alternative local service offered by carriers purchasing the TSR package. Under current rules, the incumbent LEC still collects interstate access charges when another carrier purchases and resells the TSR package. If this principle remained in place under COBAK, the incumbent LEC would have an incentive to continue to set the charges for origination services for customers served by TSR.

If, on the other hand, under COBAK, originating access were deemed a retail service subject to the requirements of Section 251(c) of the Telecommunications Act, then the rates at which a competing IXC could purchase TSR would depend on the rate structure of the underlying retail service. If incumbent LECs were to price originating access to end user customers on a per-minute basis, as described above, then IXCs would likely be required to purchase TSR by paying a per-minute rate for access. This per-minute rate would be reflected in a high per-minute end user rate for customers, putting IXCs at a competitive disadvantage.

Next, consider alternative local service that relies on the purchase of the UNEP from an incumbent LEC. It might be difficult for incumbent LECs to manipulate the pricing of the UNEP to prevent the purchasing carrier from offering more efficient retail rates, but an incumbent LEC could still disadvantage the carrier offering service based on the UNEP by degrading the quality of service in provisioning the UNEP.²² Such degradation, relative to the quality of service the incumbent LEC provides itself, would undermine the ability of competing carriers to offer a service sufficiently desirable to attract enough customers to constrain the incumbent LEC's pricing of its own local service.

The claim that the UNEP or TSR can eliminate an incumbent LEC's market power also suffers from the problem that it requires the IXC to offer a bundle of local and long distance service. That is, IXCs would be precluded from competing with incumbent LECs to provide long distance service on a stand-alone basis. Rather, IXCs would be forced to bear the risk and costs of convincing incumbent LEC customers to subscribe to both local and long distance

²² Such non-price discrimination could take a variety of forms, including delaying and disrupting the connection of service and the changeover from incumbent LEC retail service, as well as degradation of the service once it is connected.

service from an IXC in order to be able to provide long distance service on an equal footing with the incumbent LEC.

The FCC addressed a similar issue in the Line Sharing Order.²³ In that proceeding, incumbent LECs argued that competing carriers should be required to purchase a separate unbundled loop at the full UNE rate in order to provide DSL service. Competitive providers of DSL service contended that such a requirement would put them at a cost disadvantage relative to incumbent LECs that were able to offer DSL over the same loop that the subscriber used for voice service. The incumbent LECs responded that the competitive LECs also had the ability to offer voice and DSL over a single loop. The FCC rejected the incumbent LECs' position and instead allowed a lower line-sharing rate that applied to high-speed access services when the incumbent LEC provided voice service.²⁴ This ruling effectively enables competing providers of DSL service to offer their services without integrating into the provision of local voice service.

5. IT WOULD NOT BE IN THE PUBLIC INTEREST TO REVISIT INTERCONNECTION ISSUES THAT HAVE ALREADY BEEN DECIDED AND THAT ARE NOT DIRECTLY AFFECTED BY THE COBAK CHANGES.

The previous sections analyzed situations in which changes that a COBAK regime would make in cost assignments would create opportunities for incumbent LECs to exercise their continuing market power to disadvantage competitors. Because market power would be manifested in new ways, existing rules to constrain that market power would not be fully effective. In other cases, however, COBAK would not change cost assignments or the way in which incumbent LECs would attempt to exercise their market power. Currently, a number of existing rules are designed to restrain the incumbent LECs' use of market power. Where COBAK cost assignments do not affect the exercise of market power that existing rules are designed to prevent, there is no reason to consider changing those rules as part of the implementation of COBAK. Indeed, a general reconsideration of such rules would itself likely impose unnecessary costs and hinder the development of competition.

²³ See In the *Matter of Deployment of Wireline Services Offering Advanced Telecommunications Capability*, FCC, CC Docket No. 98-147, Third Report and Order, Adopted November 18, 1999.

²⁴ *Id.* at ¶¶ 44-48.

5.1. Some rules need not be altered to implement the COBAK proposal

Many local interconnection rules written to implement the Telecommunications Act of 1996 need not be revisited to implement the COBAK proposal. Under the Act, the FCC imposed a variety of transport and interconnection obligations on incumbent LECs. Competing carriers, for example, may choose to carry traffic directly to incumbent LEC end offices but are not required to do so. The current rules allow competitive LECs to interconnect with an incumbent LEC at only one point in each LATA for the transport and termination of local traffic.²⁵ Incumbent LECs are required to provide transport between this interconnection point and the destination incumbent LEC end office at TELRIC-based rates.²⁶ Incumbent LECs are required to provide transport over two-way trunks “where a carrier requesting interconnection pursuant to section 251(c)(2) does not carry a sufficient amount of traffic to justify one-way trunks.”²⁷

The justification for these rules and obligations was, and continues to be, that they allow the competing carriers to avail themselves of the same economies of scope and scale the incumbent LECs enjoy because of their incumbency and existing ubiquitous networks.²⁸ To provide local service competitive with that of an incumbent LEC, competitive LECs must provide ubiquitous service that allows their customers to contact every other customer in the local calling area, including, of course, all of the customers of the incumbent LEC. In other words, a competitive LEC must be able to complete a call to every incumbent LEC central office. A competitive LEC is unlikely to have a volume of traffic to many (and perhaps any) incumbent LEC central offices sufficient to allow it to build or lease from a carrier other than the incumbent LEC a transport network to those central offices that would have an average cost of transport as low as that of the incumbent LEC. Furthermore, even if relying on their own transport network did not impose a cost disadvantage, it would be time-consuming for competitive LECs to build or assemble from other sources a ubiquitous transport network. Forcing competitive LECs to create a separate transport network would delay their ability to

²⁵ See 01-92 NPRM at ¶ 72.

²⁶ *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, FCC. CC Docket No. 96-98, First Report and Order, **Adopted** August 1, 1996 (henceforth “96-98 First R&O”) at ¶ 35.

²⁷ 96-98 First R&O at ¶ 219.

²⁸ 96-98 First R&O at ¶ 11.

offer a service competitive to that of the incumbent LECs. Consequently, it would be difficult or impossible for competitive LECs to compete with the incumbent LEC's local service on a timely basis if they were denied use of incumbent LEC facilities for transport or were charged high rates for use of those facilities. Instead, incumbent LECs are required to provide transport to competitive LECs and to do so at TELRIC rates. As 96-98 First R&O explained, TELRIC rates will allow the competitive LEC to compete on the same cost basis as the incumbent LEC.²⁹

Implementation of a COBAK intercarrier compensation regime would not alter the foregoing analysis and conclusions. Competitive LECs would still need to share the incumbent's economies of scale and scope to provide ubiquitous competitive service. Eliminating the competitive LEC's right to interconnect at a single point in a LATA and to purchase transport and termination at TELRIC rates would mean competitive LECs could no longer provide the level of service they currently are able to offer at comparable prices. It would make it more difficult, and in many locations impossible, for IXC's to offer local and long distance service on a one-stop shopping basis to compete with RBOCs as they enter long distance service. In fact, even though carriers have the right to purchase UNEs at TELRIC rates, restrictions on commingling transport with special access on the same physical path have significantly limited competing carriers' ability to use UNE transport elements.³⁰

5.2. Unnecessarily revisiting rules that constrain market power will cause harm

The COBAK proposal represents a new paradigm upon which to base interconnection policy, but not one that requires re-examining all aspects of interconnection and of all interconnection rules. The COBAK proposal was designed to allow the new regime to be created by overlaying new rules needed to implement the changes in cost assignment on the remainder of the existing interconnection rules.

²⁹ See 96-98 First R&O at ¶ 679: "Because a pricing methodology based on forward-looking cost simulates the conditions in a competitive marketplace, it allows the requesting carrier to produce efficiently and to compete effectively..."

³⁰ Competitive LECs have requested the ability to connect UNE **loops** directly to LNE shared transport for the purpose of "extending the **loop**" beyond the central office. This would allow the competitive LEC to reduce both the number of switches it requires and the number of end offices in which they need to collocate.

A general reconsideration of these rules and obligations that govern local interconnection between incumbent LECs and competitive LECs could hinder the development of competition and harm consumers. The underlying rationale for the adoption of constraints on incumbent LEC behavior remains valid under a COBAK regime: constraints limit the ability of incumbent LECs to use their control of a ubiquitous network to disadvantage rival local carriers in ways that would harm competition and consumers. Hence, revisiting those rules would be unnecessary if the FCC were to adopt this new system for intercarrier compensation.

A general reconsideration of these rules also is undesirable because it likely would lead to a period of regulatory uncertainty while new rules were established and implemented. Such a period, as the experience since 1996 demonstrates, can be quite protracted, due not only to the process of regulatory rulemaking but also to the lengthy, post-rulemaking judicial challenges to the FCC's orders. Such uncertainty generates a variety of costs.

First, the uncertainty created by a general reconsideration of local interconnection rules likely would have a substantial adverse effect on entrants and less or no adverse effect on incumbent LECs. In particular, uncertainty about the regulatory environment would make it more difficult and expensive for entrants to obtain financing. The rules whose status would be placed in doubt by a general reconsideration directly affect the cost of interconnection for new entrants and their ability to compete effectively with the incumbent carriers. The likely consequence of the resulting uncertainty would be an increase in the cost of capital, which would make it more expensive for entrants to develop new and innovative services and to expand into new markets. Consequently, consumers would lose the benefits of the new services themselves as well as the increased competitive pressure they would exert on incumbent LEC prices.

Second, regulatory uncertainty may cause competitive LECs to delay the rollout of new services or the expansion of existing services until the uncertainty is resolved. An increase in the level of uncertainty makes it more difficult for businesses to evaluate the profitability of their plans. As such, this creates an incentive for businesspersons to delay the implementation of their plans until the uncertainty is resolved. In the parlance of modern economics, increasing

uncertainty increases the option value of waiting to incur the sunk costs of investment.³¹ These effects also would discourage investment in new services, to the detriment of consumers.

Third, regulatory uncertainty may allow the incumbent LECs to delay cooperating with a competitor that is attempting to roll out new or expand existing services. An incumbent LEC may use the uncertainty as a reason not to enter into an interconnection agreement for a new service that a competitor wants to provide, arguing that its interconnection obligations may change in the near future as a result of revisiting existing interconnection rules. Again, this would ultimately harm consumers by reducing services available from competitors.

Fourth, competing carriers would bear the cost of having to participate in regulatory proceedings to reaffirm rights and protections they already have, as well as the risk of unsatisfactory outcomes. This diverts resources from the development of new services and other activities that would make entrants more effective competitors and speed the transition from monopoly to competition. It is also possible that the resources of incumbent LECs could be diverted to the regulatory arena and away from developing services for customers. Such a diversion, however, would be particularly harmful to customers because the incumbent LEC expends resources in the regulatory arena to reduce the effectiveness of competitors.

Fifth, the existence of “deep pockets” could result in outcomes that may not be in the best interest of consumers. To the extent that incumbent LECs, and RBOCs in particular, have “deeper pockets” than entrants (even entrants the size of AT&T), protracted regulatory proceedings would harm entrants more than incumbents and delay the transition from monopoly to competition. That is, if an entrant knows it cannot for financial reasons litigate a matter to its conclusion, it will have an incentive to agree to less favorable terms.

Sixth, all else equal, incumbents have a greater payoff from “investing” in such regulatory proceedings than entrants. If the incumbent LECs prevail, their reward is to participate in a market with less competition because their efforts will have kept competitors from entering and driving prices down towards competitive levels. Thus, a successful incumbent

³¹ See generally Avinash Dixit and Robert Pindyck, *Investment Under Uncertainty* (Princeton: Princeton University Press, 1993).

LEC earns greater profits. However, if entrants prevail, their reward is to participate in a market opened to competition in which firms will only be able to earn a normal profit.

Finally, prolonging any period of uncertainty favors the incumbent LEC if that uncertainty harms competitors and reduces their ability to enter new markets, win new customers, and earn a return on their investment. Prolonging uncertainty helps to maintain the market status quo in which the incumbent LEC continues to serve most customers and earn profits. Thus, incumbent LECs would have an incentive to prolong a general reconsideration of rules.

Note that this analysis should not be construed as **an** endorsement of every rule outside of those implicated by the COBAK proceeding. It is possible that specific rules other than those required to implement a unified intercarrier compensation regime may need revision, whether or not the compensation regime changes. Presumably, however, the justification for such changes would be quite independent of the adoption of COBAK. If that is the case, then those items should be considered if the Commission concludes that the potential benefit of reconsidering specific new rules outweighs the costs of the uncertainty associated with a new proceeding. The important point in this section is that the implementation of COBAK creates no special need for a *de novo* re-examination of these rules. Rather, any revisions should be considered separately on their own merits.

6. COSTS OF IMPLEMENTING COBAK ON A PIECEMEAL BASIS

The COBAK approach is intended to be a unified interconnection regime in which the same rules apply to all traffic, local and toll, as well as Internet. The uniform treatment of all traffic would eliminate arbitrage opportunities and create a cost assignment regime that would lead to efficient prices for all types of service and traffic. In contrast, implementing a COBAK regime for local traffic before toll traffic would leave untouched some opportunities for arbitrage and delay realization of some efficiencies that COBAK could generate.

6.1. Piecemeal adoption does not eliminate access arbitrage

One of the most important features of the COBAK proposal is that it would eliminate the regulatory arbitrage that currently exists between a traditional interexchange call carried by an IXC and that same call carried by an ISP. Implementing COBAK for local calls alone will not eliminate the access arbitrage.

A traditional IXC now pays both originating and terminating access to complete a call, effectively incurring a per-minute cost for switching and transport at both the originating and terminating ends of the call. In areas where customers pay flat-rated service for dial-up local service or for DSL service, neither the customer nor an ISP that carries a long distance call (over the Internet) incurs an incremental cost for connecting the customer to the ISP network on the originating end of the call. In fact, for dial-up service, the ISP, or the competitive LEC that serves it,³² receives termination payment under the reciprocal compensation regime for completing the originating call. On the terminating end, the ISP does bear the cost of terminating the call to the called party, which is set by reciprocal compensation rates that cover transport and terminating switching.

Thus, in the situations described, the ISP will always incur a lower cost for origination of the call than a traditional IXC and, to the extent that access rates exceed transport and termination rates, also will incur a lower cost for termination than the traditional IXC. Therefore, the ISP will have lower costs for origination and termination of an interexchange call than the IXC, even though there is essentially no difference in the network facilities used for these functions. Because they have a cost advantage over traditional IXCs, ISPs, *ceteris paribus*, can set lower usage charges than the IXC and attract more customers, thus engaging in regulatory arbitrage.

Implementing COBAK for local traffic alone would mean the IXC would still have to pay originating and terminating access charges; therefore, a traditional IXC's access costs for providing an interexchange call would be unchanged. An ISP providing interexchange calling to

³² Competition among competitive LECs to serve an ISP can be expected to cause these LECs to pass much of the benefits of termination revenue through to the ISP in the form of lower service rates. Thus, an ISP is far more likely

customers using dial-up service, however, would no longer either collect termination charges on the originating end of the call for dial-up service or pay termination charges to the LEC serving the called party on the terminating end if COBAK were adopted for local traffic. If the local termination charges now paid and received by the ISP are approximately equal, their elimination would have no effect on the net costs of the ISP. Hence, adoption of COBAK for local traffic alone would do nothing to reduce the opportunity for regulatory arbitrage between the interexchange calling via IXC and ISPs using dial-up service.

6.2. Piecemeal adoption of COBAK would prolong the inefficiencies of different provisioning processes for interconnection for interexchange and local traffic

Failing to adopt COBAK for all interexchange as well as local calling also would fail to eliminate another source of inefficiency due to different treatment of access and termination services for local and interexchange calling. An integrated competitive LEC/IXC today must provision facilities under two different regimes. Facilities provisioned for interstate calls are provisioned as feature groups and facilities for local calls are provisioned under interconnection. These facilities are provisioned at different prices and under different conditions; they have had to be kept physically separate; and provisioning involves different employees and systems of the incumbent LEC. The competitive LEC/IXC and the incumbent LEC must maintain separate back-office systems for handling these two sets of facilities. It is my understanding that all of these costs are considered costs either of providing access or of providing interconnection. The costs that are incremental to access would be recoverable in access charges from IXCs. The costs that are incremental to interconnection would be part of the forward-looking cost of interconnection and reflected in TELRIC rates. Thus, in either case the costs are borne by carriers other than the incumbent LEC.

Adoption of COBAK for all local and all interexchange calling would allow facilities for interconnection to be provisioned under a single regime, whether for local or interexchange traffic. This would reduce costs for both local and interexchange carriers, as neither would have

to be served by a competitive LEC than an incumbent LEC and, even if the ISP were not also a competitive LEC, it would still receive much of the benefits from collecting termination rates for dial-up service.

to maintain separate facilities or separate back-office systems for local and interexchange calling. Adopting COBAK only for local traffic will not allow an efficient unified provisioning process to develop. Thus, delaying implementation of COBAK for long distance traffic will delay the realization of benefits for both interexchange and local traffic.³³

7. CONCLUSION

The Commission requested comments on issues relating to the implementation of a bill and keep interconnection regime. In this declaration I have explained that, under a COBAK regime, LECs would be given new responsibilities with respect to originating access, and this would likely also give them new opportunities to exploit existing market power in ways that disadvantage rivals and to the detriment of consumers. When implementing a new regime, the Commission should consider measures that would prevent the exercise of such market power.

In many other circumstances, adopting a COBAK interconnection regime would not change the ways an incumbent LEC could exercise market power. To the extent that there are already rules in place to constrain this market power, these rules should not be revisited as **part** of the implementation process.

Finally, COBAK is designed to be unified approach to interconnection, meant to apply to all forms of traffic that use the public switched network. Implementing COBAK on a piecemeal basis could actually increase in some instances the incentives for service providers to engage in regulatory arbitrage. A piecemeal implementation would also prevent the markets from realizing all of the efficiencies that could be obtained if all facilities were provisioned under a single set of rules.

³³ A complicating factor is whether COBAK is implemented for both interstate and intrastate toll traffic. If COBAK were adopted for interstate toll traffic as well as for local traffic, but not for intrastate toll traffic, then all of the efficiencies deriving from a unified provisioning process would not be realized, if state PUCs insist on a separate provisioning process for intrastate toll facilities.

Certificate of Service

I, Barbara Nowlin, do hereby certify, that copies of the foregoing comments regarding cc docket 01-92 in the matter of Developing a Unified Intercarrier Compensation Regime have been sent to the following this 21st day of August 2001.

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